

State of California  
**Franchise Tax Board**

12.24.2009

To: Leslie Lopez, Acting Secretary  
State and Consumer Services Agency  
915 Capitol Mall, Suite 200  
Sacramento, CA 95814

From: Selvi Stanislaus, Director

**Review of the Systems of Internal Control**

## **Memorandum**

In accordance with the Financial Integrity and State Managers Accountability Act of 1983, Government Code Sections 13400 through 13407, I am submitting the enclosed report describing the review of our systems of internal control for the biennial period ended November 30, 2009.

As statutorily required, the Franchise Tax Board is in compliance with Government Code Section 12439. Testing was performed on a sample of positions that were vacated, reclassified, abolished and re-established. No exceptions were noted.

If there are any questions regarding the information in this report, please feel free to contact the FTB Internal Audit Bureau Director, Philip Yu, at 845-3388.

Selvi Stanislaus  
Executive Officer

Enclosure

cc: Hon. Arnold Schwarzenegger, Governor  
Legislature, CA State Senate  
Legislature, CA State Assembly  
Elaine M. Howle, State Auditor  
Michael C. Genest, Director of Department of Finance  
Susan Hildreth, State Librarian  
Lisa Crowe, Division Chief, Franchise Tax Board  
Lisa Garrison, Chief Financial Officer, Franchise Tax Board  
Geoff Way, Chief Counsel, Franchise Tax Board

**CALIFORNIA FRANCHISE TAX BOARD**

*Financial Integrity and State Manager's Accountability Act*

*Government Code Sections 13400-13407*

*Review on  
System(s) of Internal Accounting and Administrative Control*

**INTERNAL AUDIT BUREAU  
December 2009**

## Introduction

In accordance with the Financial Integrity and State Manager's Accountability (FISMA) Act of 1983, Franchise Tax Board (FTB) submits this report on the review of our systems of internal control for the biennial period ended December 31, 2009.

Should you have any questions, please contact the FTB Internal Audit Bureau Director, Philip Yu, at (916) 845-3388 or at Philip.Yu@ftb.ca.gov.

## Background

The primary function of the Franchise Tax Board is to administer the California Revenue and Taxation Code. Franchise Tax Board administers two major tax programs, the Personal Income Tax and the Corporation Income Tax, as well as other non-tax programs and delinquent debt collection functions, including delinquent vehicle registration and debts owed to California courts and the Department of Industrial Relations.

Franchise Tax Board's mission is to collect the proper amount of tax revenue, and operate other programs entrusted to us, at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness. Our strategic goals are:

- Improve Customer Service
- Increase Fairness and Compliance with Tax Law
- Increase Transparency
- Create a Great Place to Work, Contribute, and Learn
- Demonstrate Operational Excellence
- Protect Taxpayer Information and Privacy

FTB serves California by administering programs that generate more than \$60 billion annually. Each year, our department processes more than 15 million personal income tax returns and one million business returns. Combined, the tax programs comprise over 64 percent of the state's general fund. We employ over 5,800 permanent and 2,000 seasonal and intermittent employees nationwide.

In administering these programs, we assist taxpayers in many ways. We coordinate the development of tax forms based on legislation and input from various FTB bureaus, relay new forms data to the Office of State Printing (OSP) for printing and distribution, and coordinate the availability of tax forms on the FTB Website. We offer tax help through our toll-free telephone assistance line, and we provide a wealth of information on our website 24/7. We also provide public service (e.g., filing assistance, receiving payments, and releasing levies) during normal business hours at our six California field offices. Furthermore, we provide filing assistance to various groups through our Volunteer Program, which includes volunteer income tax assistance, tax counseling for the elderly, and military tax preparation assistance.

Our tax audit activities include examining taxpayer income tax returns, determining the correctness of tax liabilities, notifying taxpayers of assessments, and resolving taxpayer disputes. We aggressively pursue investors in and promoters of abusive tax avoidance transactions and

shelters that are used to improperly understate significant amounts of tax liability. These transactions are complex and are typically reported on a tax return in a way to avoid or hinder detection.

We collect unpaid personal and corporation income tax, as well as other debts entrusted to us. Our automated system initiates the billing process. Our collection staff conducts manual collection efforts including: locate the debtor, attach assets, refer cases to collection agencies, respond to critical correspondence and calls, provide information, negotiate resolution, file bankruptcy and probate claims, and process excess collections and issue refunds.

### *FTB's Environment*

The control environment sets the tone of an entity and is the foundation for all other components or internal control, providing discipline and structure. Codes of conduct and other policies regarding acceptable business practices, conflicts of interest, or expected standards of ethical and moral behavior exist, are communicated to employees and acknowledged by their signature annually. FTB's Mission and Values Team provide presentations and resources to enhance our working environment.

FTB's management is aware that state government is experiencing its largest wave of retiring state employees in history, and the accompanying loss of knowledge and experience. They are leveraging skilled, knowledgeable retired annuitants for knowledge transfer and to enhance the competence of existing staff.

FTB's executive management is comprised primarily of accountants, auditors, and lawyers, who are conservative in accepting risks, moves carefully, and proceeds only after carefully analyzing the risks and potential benefits of an action. Senior management has a positive attitude toward internal control and the audit function.

FTB has appropriately centralized and decentralized given the nature of our operations (i.e., allocating more resources for software management, separating software and hardware responsibilities). Information flows well through the organization and employees are empowered to correct problems or implement improvements.

Human Resource policies and procedures are established for hiring, training, and promoting employees; and management communicates expectations about the people to be hired or participates directly in the hiring process. Staff is made aware of their responsibilities, expectations, performance and suggestions for improvement by an annual performance appraisal. FTB has a positive control environment.

Risk analysis is the identification and analysis of risks to the achievement of our objectives, along with determining how the risks should be managed. FTB has designated personnel, Leadership Support, to develop and maintain the department's strategic and business plans; identify and examine critical issues facing the department and make decisions resulting in policy development and problem resolution. FTB senior management have documented their objective setting, risk analysis, and anticipated responses in their strategic/business plans. FTB has a documented Strategic Plan and the Audit, Accounts Receivable, Filing, and Technology Divisions have strategic/business plans. Many business areas created their business plan with the assistance of the Leadership Support team.

FTB has many control agencies and rigorous reporting requirements to the Department of Finance, State Controller's Office, Department of Personnel Administration, State Personnel Board, Department of General Services, and the Legislature. This rigorous reporting funnels

down to individual business areas where the managers review actual performance versus budgets, forecasts, and prior periods to measure the extent to which targets are being reached. Policies and procedures are clear and well known in the relevant business area.

Because of the changing regulatory, budgetary, and economic conditions, information and communication has become even more critical. The staff demands it and the management are anxious to provide it. Department wide broadcasts, staff meetings, and other venues are utilized to deliver information timely and accurately. Our Executive Officer has an open door policy and invites all staff and external parties to email her with any comments or concerns.

Monitoring is a process that assesses the quality of the entity's performance over time. Operating information is integrated or reconciled with financial data. Senior managers decide which of the auditors' recommendations will be implemented and follow ups are conducted to verify implementation. The auditor gains a sufficient understanding of the entity's activities, how the system is supposed to work, and how it actually does work. Exceptions are investigated, the underlying causes are determined, and the problem is corrected. There is ongoing monitoring of internal control.

#### **Vacant Positions**

We reviewed the department's personnel actions for compliance with the provisions of Government Code Section 12439. Testing was performed on a sample of personnel transactions that reclassified, abolished and re-established vacant positions. No exceptions were noted.

#### **Risk Assessment**

Per the most recent DOF FISMA guidelines, the scope of the FISMA internal control review was broadened to encompass all aspects of FTB's operations. In the past, the scope of our review was limited to fiscal controls. Now, however, in compliance with the new guidelines, the scope of our review has been broadened to include program and processing controls, and information technology and security controls. For the two-year period 2008 and 2009, our review included the following components:

- Information Security Control Audit (ISCA) Part II –ISCA Part I was conducted to assure that the information FTB obtains from taxpayers is protected by security practices and procedures. ISCA Part II focused on one security-related control area, Access Controls, as it pertains to the Business Entities Tax System (BETS) only. We performed audit tests to evaluate whether adequate levels of security controls at the program level and access controls at the application system level were in place in order to protect against unauthorized access and use of taxpayer information.
- Department of General Services (DGS) Fuel Card Review – Reviewed policies and procedures, vehicle sign out sheets, Monthly Travel Logs (STD273), DGS monthly mileage logs, gas receipts, and DGS invoices for leased vehicles to determine whether internal controls are in place and adequate.
- PC Inventory Follow Up Review – Franchise Tax Board's (FTB) IT equipment, approximately 14,600 desktops, laptops, miscellaneous equipment, servers, and monitors are tracked in the Unicenter database. We evaluated the internal control environment of laptops and Change Order tickets established by the IT Service Desk Section. Policies and procedures were reviewed and testing was performed.

- Agency Collection Actions Review – Verified that FTB's accounts receivable collection procedures are in accordance with the State Administrative Manual (SAM) and related Governmental Code (GC) sections. These sections describe acceptable accounts receivable collection methods. Reviewed relevant or applicable policies, regulations, statutes, and procedure manuals. Verified Personal Income Tax (PIT) and Business Entities (BE) discharged accounts met specified criteria prior to discharge.
- National Automated Clearing House Association (NACHA) – In accordance with the *NACHA Operating Rules* for Internet-Initiated Entries, an audit of Internet-initiated taxpayer payments was conducted to ensure there are proper protections in place to safeguard sensitive taxpayer information. The FTB Web Pay and e-Installment Agreements (eIA) payment programs are currently the two FTB programs that provide taxpayers with the option of making payments via the Web. Accordingly, this audit was conducted in order to assure that these programs utilize appropriate security practices and procedures, including physical and system security, access controls, and network security.
- Pipeline/Payment Processing Review – FTB's *Pipeline* consists of the processing of all incoming mail such as: payments, returns, and other correspondence. The scope was narrowed to focus strictly on receiving payments, posting payments to the appropriate systems and taxpayers' accounts, and depositing payments to the correct financial institutions. Verified that Personal Income Tax (PIT) and Business Entities (BE) payments are processed correctly and posted timely. Verified that daily bank deposits are reconciled and deposited to the correct banks.
- Personal Income Tax (PIT) Penalty Review – Conducted review to ensure that the Taxpayer Information (TI) System is performing the correct PIT penalty calculations. Verified that the penalties programmed in TI match the provisions of various legislation.
- Field Office Cash Audit Review - The field offices administer multiple programs including public counter assistance, desk collections, field collections, and serving as a liaison between central office staff and the taxpayer. Performed a review of the work papers and audit reports of each field office cash audit conducted by the Field and Complex Account Collection Bureau. We ensured that the findings and responses were reasonable and appropriate, determined if they were any recurring findings from prior audits, and verified the proposed corrective actions adequately addressed the findings and strengthened internal controls.
- Enterprise Risk-Based Audit Plan – Per DOF FISMA guidelines, each agency is to perform an organization wide risk assessment to determine high risk areas for future audits. FTB has seven divisions: Accounts Receivable Management, Administrative Services, Audit, Filing, Finance & Executive Services, Legal, and Technology Services. We have completed the risk analysis of the Filing Division, and are currently performing risk analyses on the Audit Division, Administrative Services Division, and the Technology Services Division. Once these risk analyses are complete, we will have identified those areas that pose the most significant risk to the Department. While Internal Audit's focus is on FTB's operations and core business processes, FTB's executive management team, the Governance Council, is focused on strategic and tactical risks.

The Governance Council (GC) is a decision-making body responsible for managing information technology (IT) and business issues at the departmental level. FTB's governance structure has evolved toward setting a strategic focus for the entire

department for issues that have impacts crossing administrative/divisional lines. It is comprised of the seven Division Chiefs, along with the Executive Officer and Assistant Executive Officer. The Governance Council has quarterly meetings where the risk status and mitigation efforts are monitored. The Governance Council's risk assessment for 2007/2008 and 2008/2009 includes:

- Federal Certification of the California Child Support Automation System
- Unclaimed Payments/Suspense Credits
- Major long-term systems crash
- Ready Return risks
- Loss of Confidential Information
- External website going down during filing season
- Call center access levels and complaints
- Loss of Workforce
- Growing Backlogs

#### **Evaluation of Risks and Controls**

The Governance Council's risk assessment is management's determination of FTB's greatest vulnerabilities. They brainstorm to derive the most pressing risk issues, assign a risk owner, take actions to mitigate the risk, and meet quarterly to monitor the progress. Of the above mentioned risks, Federal Certification of the California Child Support Automation System, Unclaimed Payments/Suspense Credits, major long-term systems crash, and Ready Return risks have been resolved/mitigated. The following are the remaining risks and their mitigation strategies.

Loss of Confidential Information – Information Security audits, segregated servers for sensitive information, full encryption, and Proofpoint software to limit transmission of electronic information outside of FTB.

External website going down during filing season – IT activities to improve the web infrastructure, and develop an offsite redundancy for critical website applications.

Call Center access levels and complaints – Leverage the Web and Interactive Voice Response (IVR) to increase self-service, streamline and clarify wording on bills, and adjust mailing of bills to level call volume.

Loss of workforce – Effective recruitment, hiring, development, and retention of employees; enhance knowledge transfer through documentation of systems, processes, and procedures; utilize employees with technical knowledge for documentation and mentoring of less experienced workers.

Growing Backlogs – Re-engineer internal processes for greater efficiencies, enhance internet to assist taxpayer in self-service options, established an Outlook Inbox for faxed correspondence for easier assignment and monitoring.

Risk assessment and mitigation efforts are a top priority at FTB. Because of the Governance Council's serious attention and diligence, our greatest risks are addressed and resources are directed at reducing risk. This is monitored quarterly. This is supplemented by Internal Audit's review of operational and business risks. We are conducting an enterprise risk-based assessment of the organization to identify high risk areas for future audits. Due to the furloughs and other mandated audits, we have reviewed approximately half of the organization. We plan on completing the enterprise wide risk assessment by the next FISMA reporting. Because of the Governance Council's focus on risk assessment and mitigation efforts, coupled with the lack of material findings by Internal Audit, FTB is deemed to have adequate controls.

## Conclusion

Although the various audits performed throughout 2008 and 2009 resulted in recommendations for improvements to business processes, our review of internal controls did not reveal any material inadequacy or material weakness in the Franchise Tax Board's systems of internal accounting and administrative control that would prevent the head of the agency from stating that the agency's systems are adequate and in compliance with the FISMA Act. In our opinion, the systems of internal accounting and administrative control over operations in effect as of November 30, 2009, taken as a whole, were adequate and met agency responsibility to the State of California.